

8

Final Steps in the Accounting Cycle

Preparing the Income Statement	183
Preparing the Statement of Owner's Equity.....	185
Preparing the Balance Sheet	186
Recording the Year-End Adjustments.....	188
Preparing Closing Entries	189
Preparing the Post-Closing Trial Balance.....	193
General Ledger Accounts at the End of the Fiscal Year.....	193
Chapter Summary	199
Key Terms	199
Further Reading	199
Put It into Practice	200
Review Questions.....	201
Practice Exercises	202

LEARNING OUTCOMES

After reading this chapter, you should be able to:

- prepare and interpret financial statements
- journalize and post adjusting entries to the general ledger
- journalize and post closing entries
- prepare a post-closing trial balance

Once the worksheet is completed, you have the information needed to prepare **financial statements** for the period. In our case, we will prepare the statements as of the end of the year for Justin Case. The financial statements must be prepared in the following order:

1. Income statement
2. Statement of owner's equity
3. Balance sheet

Figure 8.1 highlights these final steps in the accounting cycle.

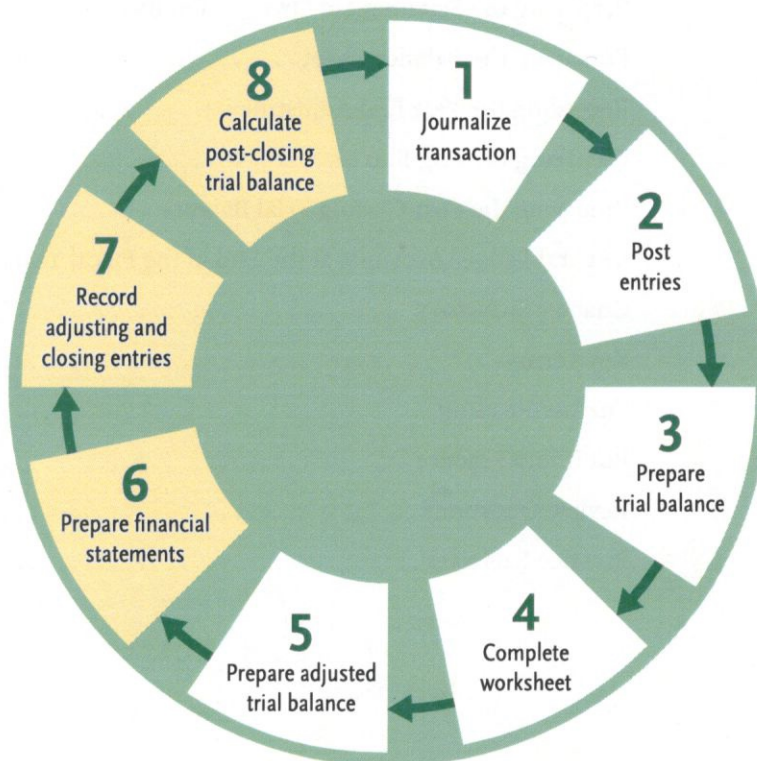


FIGURE 8.1 Steps in the accounting cycle

The worksheet prepared in Chapter 7 will be used for preparation of the **income statement**, the **statement of owner's equity**, and the **balance sheet**. You will also need the worksheet to record the adjusting entries in the general journal in order to make them part of the firm's permanent record.

Preparing the Income Statement

Income statements show the income earned less expenses incurred over a period of time to determine whether the firm has made a profit or a loss. If the firm's total income is higher than the total expenses, the firm has a profit. If the firm's expenses are higher than total income, the firm has suffered a loss. The profit or loss for the period affects the owner's capital account because losses are deducted from the capital account and profits are added to the capital account. The amount of profit or loss calculated on the income statement is needed in order to prepare the statement of owner's equity.

Steps in Preparing the Income Statement

The information you need to prepare the income statement is found on the worksheet for the end of the period.

When preparing the income statement, keep the following points in mind:

1. The heading section has three lines: the name of the firm, the name of the statement, and the period covered by the statement.
2. Although the form used has two columns for calculations, they are not debit and credit columns. The inside column is used to list numbers and for subtotalling, and the outside column is used for the totals.
3. The amounts you need are found on the worksheet in the Income Statement column.
4. The statement has four main parts:
 - a. *Heading*: Place the name of the firm, the name of the statement, and the period covered by the statement in the heading. Income statements report on the income earned over a period of time, whether a month, a quarter, or a year. The heading should have a statement saying "for the Period Ended _____."
 - b. *Income*: List each source of income below the heading "Income" (or "Revenue") in the body of the statement. If there is only one source of income, place the amount in the outside column. If there is more than one source of income, list the source account name, indented under the heading "Income." Then place the amounts in the inside column. Draw a line under the last number entered, and place the total income in the outside column.
 - c. *Expenses*: List each expense account that has a balance and enter the amount in the inside column. Place a line under the last number and enter the total in the outside column on the "Total Expenses" line at the end of the list.
 - d. *Net income or net loss*: Take the difference between the total income and the total expenses to calculate the net income or net loss. The net income or net loss should be the same as the amount that was calculated on the worksheet. Negative values are recorded in parentheses to indicate net loss.

Figure 8.2 illustrates these points.

The information contained in the income statement is not only useful to the owner of the firm, but will also be of interest to the firm's banker if there is an outstanding line of credit and, of course, to the Canada Revenue Agency for income tax purposes. In a sole proprietorship, the net income shown on the income statement represents the taxable income of the owner. Remember that drawings (withdrawals) are what the owner took out of the business for personal use. Income tax will be payable on the net income for the firm if it is a sole proprietorship.

Justin Case, Paralegal Income Statement for the Period Ended December 31, 20**		
Income		
Fees Earned		\$31,580.00
Expenses		
Meals and Entertainment Expense	\$350.00	
Membership/Professional Dues	1,343.75	
Office Supplies/General Expense	1,010.00	
Rent Expense	1,100.00	
Salaries Expense	1,200.00	
Telephone Expense	479.34	
Insurance Expense—Professional Liability	50.00	
Depreciation Expense	326.01	
Interest Expense	<u>100.00</u>	
Total Expenses		<u>5,959.10</u>
Net Income		<u><u>\$25,620.90</u></u>

FIGURE 8.2 Income statement

Interpreting Information from the Income Statement

The income statement will help to provide answers to the following questions.

With regard to income:

1. Is the income earned during the period covered by the statement reasonable considering the amount of time and effort spent?
2. Should a review of billing practices be done to see if work completed is being billed effectively?
3. Does the owner need to work harder to increase the amount of income being earned?
4. Is the income earned during the period enough to cover the expenses incurred over the same period? If not, what needs to be done to improve the situation?

With regard to expenses:

1. Review each of the expenses listed to determine whether the amount being spent on each account is reasonable.
2. Can the firm afford to increase salaries expense? Would bringing in extra help assist in increasing revenues?
3. Does the firm need to cut back to reduce expenses (especially if expenses are higher than income)? If so, where can the firm cut back?

Preparing the Statement of Owner's Equity

The second statement that must be prepared is the statement of owner's equity. This statement will calculate the owner's equity in the firm, taking into account any additional investment made by the owner over the period and the net income or net loss for the period. Withdrawals also serve to reduce the owner's equity in the firm. The amount calculated for owner's equity at the end of the period will be carried over to the balance sheet.

The statement of owner's equity shows how the net income or net loss affects owner's equity. Remember the expanded accounting equation (see also Figure 2.3 in Chapter 2):

$$\text{Assets} = \text{Liabilities} + \text{Capital} - \text{Withdrawals} + (\text{Income} - \text{Expenses})$$

The statement of owner's equity calculates the increase or decrease in the owner's equity in the firm over the period covered by the statement. This number obtained for owner's equity can then be inserted when completing the balance sheet.

The steps for preparing the statement of owner's equity are as follows:

1. The heading section has three lines: the name of the firm, the name of the statement, and the period covered by the statement.
2. The form used for preparing the statement of owner's equity also uses columns for calculations. The columns do not designate debit and credit entries.
3. The amounts are taken from the worksheet in both the Income Statement and the Balance Sheet columns.
4. You must first enter the owner's capital at the beginning of the period as shown on the Balance Sheet column in the worksheet. Place this amount in the outside column.
5. The net income was calculated using the income statement. The next line is the net income or net loss for the period. Take the amount shown on the income statement you just prepared and place that amount in the inside column.
6. On the next line, you need to show any withdrawals that were made by the owner during the period. This amount needs to be deducted from the net income. If there was a net loss, the net loss and the amount of withdrawals will be added together.
7. On the next line, indicate whether there was an increase or a decrease in the capital account.
 - a. In the case of a net profit: calculate net income less withdrawals. If the figure is positive, there has been an increase in the capital account. If the figure is negative, there has been a decrease in capital.
 - b. In the case of a net loss: total the net loss and the withdrawals taken during the period. The total is the decrease in capital that occurred over the period.
 - c. Enter the amount of the increase or decrease in capital and extend the calculation to the outside column.
8. Total the outside column to arrive at the capital at the end of the period. In the case of a decrease in capital, subtract the decrease from the first line (owner's capital at the beginning of the period). In the case of an increase in capital, add the increase to the first line (owner's capital at the beginning of the period). This total amount will be used in completing the owner's equity portion of the balance sheet.

Figure 8.3 illustrates these points.

Justin Case, Paralegal Statement of Owner's Equity for the Period Ended December 31, 20**		
Justin Case, Capital, December 1, 20**		\$2,550.00
Net Income for December	\$25,620.90	← From income statement
Less: Withdrawals for December	1,800.00	← From balance sheet
Increase in Capital		<u>23,820.90</u>
Justin Case, Capital, December 31, 20**		<u>\$26,370.90</u>

FIGURE 8.3 Statement of owner's equity

Interpreting Information on the Statement of Owner's Equity

The statement of owner's equity at the end of a period helps to provide answers to the following questions:

1. Has the owner's investment in the firm increased or decreased? In other words, is the investment in the firm worth more or less than at the beginning of the period?
2. How much could the owner justify asking for the firm if he or she decided to sell it?
3. How much should the owner ask a partner to invest in the firm if the owner wanted to take one on? If a partner were to receive a 50 percent interest in the firm, it would be wise to ask that he or she invest 50 percent of the amount of capital at the end of the period.

Preparing the Balance Sheet

Now that you have calculated the owner's equity at the end of the period, you are able to complete the balance sheet. This form can be laid out in different ways. The balance sheet is often laid out with the assets on one side and the liabilities and owner's equity on the other in the shape of a T-account (see, for example, Figure 2.2 in Chapter 2).

Accounting software tends to lay out the balance sheet by placing the assets at the top of the page and the liabilities and owner's equity below. This is the format we will use for the purposes of this chapter. When the balance sheet is laid out this way, the three last columns are usually used for calculations, two for calculating subtotals and the last one for calculating the final numbers, as shown in Figure 8.4.

Follow these steps to prepare the balance sheet:

1. The amounts you will enter on the balance sheet are found in the Balance Sheet column of the worksheet and on the statement of owner's equity.
2. The heading for the balance sheet should show the name of the firm, the name of the financial statement, and the date. A balance sheet gives a snapshot of the firm at a particular date, so the date at the top does not refer to a period as in the income statement and statement of owner's equity. Rather, it shows the date for which the statement is being prepared.
3. Place the title "Assets" above the first column. Place the title "Current Assets" below near the margin, and place the value of each asset in the third column. Total the value of the current assets, and enter the total current assets in the outside column.

4. Note that the first number in the column has a dollar sign, and then the grand totals. Follow this convention.
5. Place the title “Fixed Assets” below and list the value of the assets in the third column, except for any assets that have been depreciated. You will need to place their value in the second column so that you can show the historical cost and the accumulated depreciation, and then place the resulting value in the third column (see Figure 8.4).

Justin Case, Paralegal Balance Sheet December 31, 20**			
Assets			
Current Assets			
General Bank Account		\$4,906.91	
Trust Bank Account		15,280.00	
Accounts Receivable		25,000.00	
Prepaid Insurance		550.00	
Office Supplies		<u>200.00</u>	
Total Current Assets			\$45,936.91
Fixed Assets			
Computer Equipment (Hardware)	\$6,520.00		
Less: Accumulated Depreciation on Computer Equipment	<u>326.01</u>	6,193.99	
Office Furniture and Equipment		<u>2,250.00</u>	
Total Fixed Assets			<u>8,443.99</u>
Total Assets			<u>\$54,380.90</u>
Liabilities and Owner's Equity			
Liabilities			
Accounts Payable/General Liabilities		6,890.00	
Personal Loan		3,100.00	
Credit Card Debt		2,500.00	
Accrued Salaries Payable		240.00	
Trust Funds Owed		<u>15,280.00</u>	
Total Liabilities			28,010.00
Owner's Equity			
Justin Case, Capital			<u>26,370.90</u>
Total Liabilities and Owner's Equity			<u>\$54,380.90</u>

← From Statement
of Owner's Equity

FIGURE 8.4 Balance sheet

6. Once you have completed the calculations, the totals are carried over to the last column and totalled.
7. Place the total value of assets in the outside column. Place a dollar sign in front of the number and a double underline under the total.
8. Complete the liabilities section by listing the liabilities as shown on the worksheet. They should be totalled and the sum placed in the outside column.
9. Enter the amount of the capital that was calculated on the statement of owner's equity in the owner's equity section.
10. Add the total liabilities and owner's equity together. This number should be equal to the total assets shown above.
11. You have now completed the balance sheet. Place a double underline under the total for liabilities and owner's equity.

Interpreting Information from the Balance Sheet

The balance sheet will help to provide answers to the following questions:

1. Does the firm have sufficient resources to meet its liabilities?
2. Does the firm need to seek additional investment to meet its expenses or to expand?
3. How old are the outstanding accounts receivable? Should steps be taken to have accounts paid more quickly so that they do not become bad debts? In that regard, does the firm need to consider increasing the amounts charged for retainers from clients so that accounts are paid in a timely manner?
4. Does the firm have excess cash that should be invested in short-term or long-term investment vehicles to gain interest income?
5. Are the debts excessive in relation to the owner's investment? If so, is the firm at risk of going bankrupt?

Once you have completed the financial statements, you are ready to close the books for the year. You will need to record the adjusting entries that were entered in the worksheet and also prepare the year-end **closing entries**.

Recording the Year-End Adjustments

The year-end adjustments that were made on the worksheet must be recorded in the permanent records of the firm. You will make these entries using the general journal (see Figure 8.5).

Follow these steps to record adjusting entries:

1. Enter the title "Adjusting Entries" on the first line.
2. Copy the entry for each adjustment from the worksheet to the general journal, listing the debit entry first and the credit entry on the second line.
3. An explanation is not required because you have placed the title "Adjusting Entries" at the top of the column. Skip one line and enter the next adjusting entry.
4. Record the entries in the Adjustments column of the worksheet (a to e in our case) by repeating steps 2 and 3 for each entry until they have all been recorded.
5. Total the debits and credits in the general journal. The totals should be the same as the totals in the Adjustments column of the worksheet.

6. Once you have entered all the adjusting entries in the general journal, post each entry to the respective account in the general ledger, indicating that the entry is an adjusting entry in the description. Remember to complete the PR numbers in the general journal and in the reference in the general ledger account as you post each entry.

Justin Case, Paralegal General Journal					GJ4
Date 20**		Description	PR	Debit	Credit
		Adjusting Entries			
Dec.	31	Insurance—Professional Liability	527	50.00	
		Prepaid Insurance	125		50.00
	31	Office Supplies/General Expense	535	430.00	
		Office Supplies	130		430.00
	31	Depreciation Expense	522	326.01	
		Depreciation—Computer Equipment	156		326.01
	31	Interest Expense	529	100.00	
		Personal Loan	205		100.00
	31	Salaries Expense	511	240.00	
		Accrued Salaries Payable	220		240.00
		Totals		1,146.01	1,146.01

FIGURE 8.5 Adjusting entries

Preparing Closing Entries

Before starting to record transactions for the new year, the books for the previous fiscal period must be closed. **Balance sheet accounts** are referred to as **permanent accounts** because their balances carry over from one fiscal period to the next. If you think about it, the balance in the bank on December 31 will carry over to the next year—it does not disappear just because your fiscal year-end has arrived. This is true of all the assets. The same goes for any liabilities outstanding—they unfortunately do not disappear just because the end of the year has come. However, income, expense, and withdrawal accounts need to be zeroed out because you need to start fresh each year. It is for that reason that these three categories of account are referred to as **temporary accounts**.

Closing entries are used to set the temporary account balances to zero at the end of the fiscal year. Closing entries:

- Allow you to accumulate new data for the income, expense, and withdrawal accounts starting with the first day of the new fiscal year.
- Enable you to update the capital account going forward by transferring the net income or net loss to a permanent account (called income summary or retained earnings).

As illustrated in the journal entries shown below, there are four steps in the process for preparing closing entries:

1. Clear the balance in the income accounts and transfer the balance to the income summary.
 - Debit income accounts/credit income summary.
2. Clear the balance in the individual expense accounts and transfer the total to the income summary.
 - Debit income summary/credit expense accounts.
3. Clear the balance in the income summary (net income) account and transfer the balance to the capital account.
 - Debit income summary/credit capital (if net income).
4. Clear the balance in the drawings account and transfer the balance to the capital account.
 - Debit capital/credit drawings.

Step 1: Closing the Income (Revenue) Accounts

Use the information shown on the income statement to close accounts.

Close all accounts with a credit balance by debiting each **income account** with a credit balance to get a zero balance. For example, in the Justin Case income statement (Figure 8.2), the Fees Earned account has a credit balance of \$31,580. Debit the Fees Earned account by that amount. To have a balanced entry, credit the **income summary account**.

General Journal				GJS
Date 20**	Description	PR	Debit	Credit
	Closing Entries			
Dec. 31	Fees Earned	400	31,580	
	Income Summary	355		31,580
	<i>To close income accounts</i>			

FIGURE 8.6 General journal closing entries—income accounts

Step 2: Closing the Expense Accounts

Close all the accounts on the income statement with a debit balance (**expense accounts**) by crediting each account. This will bring each account down to zero. Debit the income summary account. Remember that in the general journal, debits are entered on the first line and credits below so the first line of your closing entry will be income summary, followed by a list of each expense account that is being closed. Each entry must be posted to the general ledger. Once you have completed posting, all the expense accounts should have a zero balance.

General Journal					GJ5
Date 20**		Description	PR	Debit	Credit
Dec.	31	Income Summary	355	5,959.10	
		Depreciation Expense	522		326.01
		Insurance—Professional Liability	527		50.00
		Interest Expense	529		100.00
		Meals and Entertainment Expense	533		350.00
		Membership/Professional Dues	534		1,343.75
		Office Supplies/General Expense	535		1,010.00
		Rent Expense	538		1,100.00
		Salaries Expense	511		1,200.00
		Telephone Expense	565		479.34
		To close expense accounts			

FIGURE 8.7 General journal closing entries—expense accounts

Step 3: Closing the Income Summary Account

Once the closing entries for the income and expense accounts have been posted, the general ledger shows a credit balance in the income summary account. After posting, the balance in this account is equal to the net income (or net loss) of the firm. Figure 8.8 shows the income summary account after the closing entries for the income and expense accounts have been posted.

Income Summary					Account No. 355	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr. Balance
Dec.	31	To close income accounts	GJ5		31,580.00	
	31	To close expense accounts	GJ5	5,959.10		Cr. 25,620.90

FIGURE 8.8 Income summary account in general ledger

In order to clear the net income amount from the income summary account, you must create a closing entry by debiting the income summary account and crediting the capital account.

The general journal closing entry made to close the income summary account is as shown in Figure 8.9.

General Journal					GJ5
Date 20**		Description	PR	Debit	Credit
Dec.	31	Income Summary	355	25,620.90	
		Justin Case, Capital	300		25,620.90
		To close income summary account			

FIGURE 8.9 Closing entries—income summary

Step 4: Closing the Drawings Account

Clear the balance in the drawings account and transfer the balance to the capital account. The owner of a sole proprietorship takes withdrawals for personal use over the course of the year, and this account needs to be cleared. As was seen on the statement of owner's equity, withdrawals decrease the owner's equity in the firm. For this reason, the amount taken by way of withdrawals will be transferred to the capital account and used to decrease the owner's equity in the firm. This account is cleared at the end of the fiscal year. Drawings taken in the subsequent year will start from zero and be accumulated over the next year.

The closing entry required to close the drawings account is as shown in Figure 8.10.

General Journal					GJ5
Date 20**		Description	PR	Debit	Credit
Dec.	31	Justin Case, Capital	300	1,800.00	
		Justin Case, Drawings	350		1,800.00
		To close drawings into capital			

FIGURE 8.10 General journal closing entries—drawings

Once the closing entries are posted, the general ledger capital and drawings accounts will appear as in Figure 8.11.

Justin Case, Capital						Account No. 300	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	1	Balance Forward	✓		2,550.00	Cr.	2,550.00
	31	Closing Entry—Income Summary			25,620.90	Cr.	28,170.90
	31	Closing Entry—Drawings		1,800.00		Cr.	26,370.90

Justin Case, Drawings						Account No. 350	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	1	Balance Forward	✓	1,800.00		Dr.	1,800.00
	31	Closing Entry	GJ5		1,800.00		0.00

Justin Case, Income Summary						Account No. 355	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Closing Entry—Income Account	GJ5		31,580.00	Cr.	31,580.00
	31	Closing Entry—Expense Accounts	GJ5	5,959.10		Cr.	25,620.90
	31	Closing Entry—Net Income transfer to Capital	GJ5	25,620.90			0.00

FIGURE 8.11 General ledger capital, drawings, and income summary accounts after posting

Preparing the Post-Closing Trial Balance

Once all the adjusting entries and closing entries have been recorded and posted, a **post-closing trial balance** must be prepared. All temporary accounts will have been closed, and the only balances remaining in the general ledger should be in the permanent accounts. Prepare a list of all the general ledger accounts with a balance. They have been placed in numerical order in the post-closing trial balance shown in Figure 8.12.

Justin Case, Paralegal Post-Closing Trial Balance December 31, 20**			
		<i>Dr.</i>	<i>Cr.</i>
100	General Bank Account	\$4,906.91	
115	Trust Bank Account	15,280.00	
120	Accounts Receivable	25,000.00	
125	Prepaid Insurance	550.00	
130	Office Supplies	200.00	
155	Computer Equipment (Hardware)	6,520.00	
156	Depreciation—Computer Equipment		\$326.01
158	Office Furniture and Equipment	2,250.00	
200	Accounts Payable/General Liabilities		6,890.00
205	Personal Loan		3,100.00
210	Credit Card Debt		2,500.00
215	Trust Funds Owed		15,280.00
220	Accrued Salaries Payable		240.00
300	Justin Case, Capital		<u>26,370.90</u>
	Totals	<u>\$54,706.91</u>	<u>\$54,706.91</u>

FIGURE 8.12 Post-closing trial balance

General Ledger Accounts at the End of the Fiscal Year

Figure 8.13, below, shows Justin's general ledger accounts at the end of December once the year-end was completed. Note that only those accounts from December 1 (where a balance forward was recorded) to the end of December are included here. The asset, liability, and capital accounts show a balance, but the drawings, income, and expense accounts are at zero, ready to start the new fiscal year.

Justin Case, Paralegal General Ledgers

General Bank Account					Account No. 100	
<i>Date</i> 20**		<i>Explanation</i>	<i>PR</i>	<i>Debit</i>	<i>Credit</i>	<i>Dr./Cr. Balance</i>
Dec.	1	Balance Forward	✓	4,906.91		Dr. 4,906.91

Trust Bank Account					Account No. 115	
<i>Date</i> 20**		<i>Explanation</i>	<i>PR</i>	<i>Debit</i>	<i>Credit</i>	<i>Dr./Cr. Balance</i>
Dec.	1	Balance Forward	✓	15,280.00		Dr. 15,280.00

Accounts Receivable					Account No. 120	
<i>Date</i> 20**		<i>Explanation</i>	<i>PR</i>	<i>Debit</i>	<i>Credit</i>	<i>Dr./Cr. Balance</i>
Dec.	1	Balance Forward	✓	25,000.00		Dr. 25,000.00

Prepaid Insurance					Account No. 125	
<i>Date</i> 20**		<i>Explanation</i>	<i>PR</i>	<i>Debit</i>	<i>Credit</i>	<i>Dr./Cr. Balance</i>
Dec.	1	Prepaid Insurance	✓	600.00		Dr. 600.00
Dec.	31	Adjusting Entry	GJ4		50.00	Dr. 550.00

Office Supplies					Account No. 130	
<i>Date</i> 20**		<i>Explanation</i>	<i>PR</i>	<i>Debit</i>	<i>Credit</i>	<i>Dr./Cr. Balance</i>
Dec.	1	Balance Forward	✓	630.00		Dr. 630.00
	31	Adjusting Entry	GJ4		430.00	Dr. 200.00

Computer Equipment (Hardware)					Account No. 155	
<i>Date</i> 20**		<i>Explanation</i>	<i>PR</i>	<i>Debit</i>	<i>Credit</i>	<i>Dr./Cr. Balance</i>
Dec.	1	Balance Forward	✓	6,520.00		Dr. 6,520.00

Depreciation—Computer Equipment					Account No. 156	
<i>Date</i> 20**		<i>Explanation</i>	<i>PR</i>	<i>Debit</i>	<i>Credit</i>	<i>Dr./Cr. Balance</i>
Dec.	1	Adjusting Entry	GJ4		326.01	Cr. 326.01

Office Furniture and Equipment					Account No. 158	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr. Balance
Dec.	1	Balance Forward	✓	2,250.00		Dr. 2,250.00

Accounts Payable/General Liabilities					Account No. 200	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr. Balance
Dec.	1	Balance Forward	✓		6,890.00	Cr. 6,890.00

Personal Loan					Account No. 205	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr. Balance
Dec.	1	Balance Forward	✓		3,000.00	Cr. 3,000.00
	31	Adjusting Entry	GJ4		100.00	Cr. 3,100.00

Credit Card Debt					Account No. 210	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr. Balance
Dec.	1	Balance Forward	✓		2,500.00	Cr. 2,500.00

Trust Funds Owed					Account No. 215	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr. Balance
Dec.	1	Balance Forward	✓		15,280.00	Cr. 15,280.00

Accrued Salaries Payable					Account No. 220	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr. Balance
Dec.	31	Adjusting Entry	GJ4		240.00	Cr. 240.00

Justin Case, Capital					Account No. 300	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr. Balance
Dec.	1	Balance Forward	✓		2,550.00	Cr. 2,550.00
	31	Closing Entry—Income Summary	GJ5		25,620.90	Cr. 28,170.90
	31	Closing Entry—Drawings	GJ5	1,800.00		Cr. 26,370.90

Justin Case, Drawings						Account No. 350	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	1	Balance Forward	✓	1,800.00		Dr.	1,800.00
	31	Closing Entry	GJ5		1,800.00		0.00

Income Summary						Account No. 355	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	To close income accounts	GJ5		31,580.00	Cr.	31,580.00
	31	To close expense accounts	GJ5	5,959.10		Cr.	25,620.90
	31	To transfer balance to Capital	GJ5	25,620.90			0.00

Fees Earned						Account No. 400	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	1	Balance Forward	✓		31,580.00	Cr.	31,580.00
	31	Closing Entry	GJ5	31,580.00			0.00

Salaries Expense						Account No. 511	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	1	Balance Forward	✓	960.00		Dr.	960.00
	31	Adjusting Entry	GJ4	240.00		Dr.	1,200.00
	31	Closing Entry	GJ5		1,200.00		0.00

Depreciation Expense						Account No. 522	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Adjustment—Computer Equipment	GJ4	326.01		Dr.	326.01
	31	Closing Entry	GJ5		326.01		0.00

Insurance—Professional Liability						Account No. 527	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Adjusting Entry	GJ4	50.00		Dr.	50.00
	31	Closing Entry	GJ5		50.00		0.00

Interest Expense						Account No. 529	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Adjusting Entry	GJ4	100.00		Dr.	100.00
	31	Closing Entry	GJ5		100.00		0.00

Meals and Entertainment Expense						Account No. 533	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	1	Balance Forward	✓	350.00		Dr.	350.00
	31	Closing Entry	GJ5		350.00		0.00

Membership/Professional Dues						Account No. 534	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	1	Balance Forward	✓	1,343.75		Dr.	1,343.75
	31	Closing Entry	GJ5		1,343.75		0.00

Office Supplies/General Expense						Account No. 535	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	1	Balance Forward	✓	580.00		Dr.	580.00
	31	Adjusting Entry	GJ4	430.00		Dr.	1,010.00
	31	Closing Entry	GJ5		1,010.00		0.00

Rent Expense						Account No. 538	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	1	Balance Forward	✓	1,100.00		Dr.	1,100.00
	31	Closing Entry	GJ5		1,100.00		0.00

Telephone Expense						Account No. 565	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	1	Balance Forward	✓	479.34		Dr.	479.34
	31	Closing Entry	GJ5		479.34		0.00

FIGURE 8.13 General ledgers after closing

Legal Requirements for Keeping Records

All records, such as paper documents as well as those stored in an electronic medium (such as on computer disk), must be kept in Canada or made available in Canada at the request of the Canada Revenue Agency (CRA). The records must be in English or French.

A business is required to keep orderly records of all income received. All receipts, invoices, vouchers, and cancelled cheques indicating outlays of money must also be kept. Such outlays include

- salaries and wages,
- operating expenses such as rent, advertising, and capital expenditures, and
- miscellaneous items such as charitable donations.

Records must be permanent and contain a systematic account of income, deductions, credits, and other information needed to file income tax and GST/HST returns. Incomplete records that use approximations instead of exact amounts are not acceptable. The records must

- allow you to determine how much tax you owe, or the tax, duties, or other amounts to be collected, withheld, or deducted, or any refund or rebate you may claim; and
- be supported by vouchers or other necessary source documents. If you do not keep your receipts or other vouchers to support your expenses or claims, and there is no other evidence available, the CRA will probably reduce the expenses or claims you have made.

The Six-Year Requirement

If tax returns are filed on time, records must be retained (other than certain documents for which there are special rules) for six years from the end of the last tax year to which they relate. You must keep every record necessary for dealing with an objection or appeal until it is resolved and the time for filing any further appeal has expired, or until the six-year period has expired, whichever is later.

CHAPTER SUMMARY

In this chapter you have completed the accounting cycle up to preparation of the post-closing trial balance. The post-closing trial balance serves as a check to ensure that the ledger accounts are in balance. All the temporary accounts have been cleared, and you are ready to begin the accounting cycle over again for the next fiscal period. The post-closing trial balance contains the balances for opening the books for the new fiscal year.

The financial statements were prepared for the end of the year. They can be prepared more frequently if you need to see how the business is doing or for submitting to a lender who requires the information.

KEY TERMS

balance sheet, 182

balance sheet accounts, 189

closing entries, 188

expense accounts, 190

financial statements, 182

income account, 190

income statement, 182

income summary account, 190

permanent accounts, 189

post-closing trial balance, 193

statement of owner's equity, 182

temporary accounts, 189

FURTHER READING

Canada Revenue Agency, *Business and Professional Income 2014*, online: <<http://www.cra-arc.gc.ca/E/pub/tg/t4002/t4002-e.html>>. Financial reporting for sole proprietors.

Canada Revenue Agency, "General Index of Financial Information (GIFI)," online: <<http://www.cra-arc.gc.ca/tx/bsnss/tpcs/crprtns/rtrn/wht/gifi-ogrf/menu-eng.html>>. Corporate financial statements.

L Kenway, "Accounting and Bookkeeping Checklists," *Bookkeeping-Essentials.com*, online: <<http://www.bookkeeping-essentials.com/bookkeeping-checklist.html>>. Select the "Year End Accountant Checklist" link.

L Kenway, "Learn How to Read Your Internal Financial Reports," *Bookkeeping-Essentials.com*, online: <<http://www.bookkeeping-essentials.com/accounting-training.html>>. Select the "Balance sheet" and "Income statement" links.

MaRS Discovery District, online: <<http://www.marsdd.com/collections/accounting/financial-statements>>. See the following topics:

- "Reading a Financial Statement: The Balance Sheet (Assets, Liabilities and Equity)." <<http://www.marsdd.com/mars-library/reading-financial-statement-balance-sheet-assets-liabilities-equity>>.
- "Reading a Financial Statement: The Income Statement." <<http://www.marsdd.com/mars-library/reading-financial-statement-income-statement>>.
- "Accounting Mechanics: An Example of Financial Statements." <<http://www.marsdd.com/mars-library/financial-statement-example>>.

PUT IT INTO PRACTICE

Case Example: Year-End Financial Statements

Ann Litigate had a meeting with her accountant, who advised her that there were some discrepancies in the information Ann provided. Consequently, the year-end financial statement will have to be adjusted and revised.

1. What steps can Ann take to ensure that the accountant has all the relevant information and that such information is accurate? Discuss.
2. What are some common issues with financial statement preparation that Ann can avoid next time? Discuss.

REVIEW QUESTIONS

True or False

- _____ 1. The income statement calculation will determine the taxable income for a business owner.
- _____ 2. At closing, all temporary and permanent account balances are brought to zero.
- _____ 3. The post-closing trial balance includes only the permanent accounts: assets, liabilities, and equity.
- _____ 4. To close the revenue accounts, you debit the revenue accounts.
- _____ 5. The income summary is a permanent account that is transferred to the opening balance in the next fiscal period.
- _____ 6. To close the expense account, you debit the expense account.
- _____ 7. To close the income summary account, you transfer the ending balance to the capital account.
- _____ 8. The ending balances on the general ledger and the post-closing trial balance become the opening balances in the new fiscal period.
- _____ 9. At the close of the fiscal year, the general ledger accounts must be updated to reflect all adjustments.
- _____ 10. The post-closing trial balance serves as a check to ensure that the ledger accounts are in balance.

Short Answer

1. What information does the statement of owner's equity report? Why is this important?
2. What happens to the drawings account at the end of the accounting cycle?
3. What information does the general ledger report at the end of the accounting cycle?
4. What are the four steps involved in closing the accounts at the end of the accounting cycle?
5. Name two categories of accounts that are "permanent accounts."
6. Name three categories of accounts that are "temporary accounts."

PRACTICE EXERCISES

Practice Exercise 8.1

- a. Using the balances obtained in Practice Exercise 7.4, prepare the financial statements for the period ended December 31, 20**.

PRACTICE

EXCEL

Ann Litigate, Paralegal Income Statement for the Period Ended December 31, 20**		
Income		
Fees Earned		
Expenses		
Salaries Expense		
Depreciation Expense		
Insurance—Professional Liability		
Membership/Professional Dues		
Office Supplies/General Expense		
Rent Expense		
Telephone Expense		
Total Expenses		
Net Income		

Ann Litigate, Paralegal Statement of Owner's Equity for the Period Ended December 31, 20**		
Ann Litigate, Capital, December 1, 20**		
Net Income for December		
Less: Withdrawals for December		
Increase in Capital		
Ann Litigate, Capital, December 31, 20**		

Ann Litigate, Paralegal Balance Sheet December 31, 20**			
Assets			
Current Assets			
General Bank Account			
Trust Bank Account			
Accounts Receivable			
Prepaid Insurance			
Office Supplies			
Total Current Assets			
Fixed Assets			
Computer Equipment (Hardware)			
Less: Accumulated Depreciation on Computer Equipment			
Total Fixed Assets			
Total Assets			
Liabilities and Owner's Equity			
Liabilities			
Accounts Payable/General Liabilities			
Credit Card Debt			
Trust Funds Owed			
Total Liabilities			
Owner's Equity			
Ann Litigate, Capital			
Total Liabilities and Owner's Equity			

PRACTICE

EXCEL

- b. Record the adjusting entries in Ann's general journal, then post the amounts to the individual general ledger accounts.

PRACTICE

EXCEL

[illegible]

- c. In the same general journal, once the adjusting entries have been posted, prepare the closing entries and post them to the general ledger. Use the same general journal and general ledgers you used for part (b).

PRACTICE**EXCEL**

**Ann Litigate, Paralegal
General Ledgers**

General Bank Account						Account No. 100	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓			Dr.	15,360

Trust Bank Account						Account No. 115	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓			Dr.	18,500

Accounts Receivable						Account No. 120	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓			Dr.	3,500

Prepaid Insurance						Account No. 125	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓			Dr.	3,000

Prepaid Expense						Account No. 128	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1 (rent)	✓			Dr.	1,200

Office Supplies						Account No. 130	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓			Dr.	800

PRACTICE**EXCEL****Computer Equipment (Hardware)****Account No. 155**

Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓			Dr.	6,800

Depreciation—Computer Equipment**Account No. 156**

Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓				0

Accounts Payable/General Liabilities**Account No. 200**

Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓			Cr.	6,500

Credit Card Debt**Account No. 210**

Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓			Cr.	4,500

Trust Funds Owed**Account No. 215**

Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓			Cr.	18,500

Ann Litigate, Capital**Account No. 300**

Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓			Cr.	12,500

PRACTICE
EXCEL

Ann Litigate, Drawings						Account No. 350	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓			Dr.	2,000

Income Summary						Account No. 355	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance

Fees Earned						Account No. 400	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1				Cr.	10,550

Salaries Expense						Account No. 511	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓			Dr.	1,000

Depreciation Expense						Account No. 522	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓				0

Insurance—Professional Liability						Account No. 527	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓				0

PRACTICE**EXCEL**

Membership/Professional Dues						Account No. 534	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓			Dr.	230

Office Supplies/General Expense						Account No. 535	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓				0

Rent Expense						Account No. 538	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓				0

Telephone Expense						Account No. 565	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓			Dr.	160

- d. Using the general journal and general ledgers from parts (b) and (c), close the income summary and drawings accounts to the Ann Litigate, Capital account. Then prepare the post-closing trial balance.

Ann Litigate, Paralegal Post-Closing Trial Balance December 31, 20**			
	Account Titles	Dr.	Cr.
100	General Bank Account		
115	Trust Bank Account		
120	Accounts Receivable		
125	Prepaid Insurance		
128	Prepaid Expense (Rent)		
130	Office Supplies		
155	Computer Equipment (Hardware)		
156	Depreciation—Computer Equipment		
200	Accounts Payable/General Liabilities		
210	Credit Card Debt		
215	Trust Funds Owed		
300	Ann Litigate, Capital		
	Totals		

PRACTICE

EXCEL

PRACTICE**EXCEL****Practice Exercise 8.2**

- a. Using the worksheets provided, prepare the financial statements for ABC Legal Services based on the adjusted trial balance shown below. Assume that the adjustments have been entered in the journal (GJ2) and have been entered and posted to the account ledgers.

ABC Legal Services Adjusted Trial Balance December 31, 20**		
Account Titles	Dr.	Cr.
General Bank Account	\$15,000	
Trust Bank Account	35,000	
Accounts Receivable	20,250	
Prepaid Insurance	700	
Prepaid Expense (Rent)	700	
Office Supplies	150	
Computer Equipment (Hardware)	4,750	
Depreciation—Computer Equipment		\$950
Accounts Payable/General Liabilities		2,025
Personal Loan		6,000
Credit Card Debt		4,500
Trust Funds Owed		35,000
ABC, Capital		17,165
ABC, Drawings	5,000	
Fees Earned		23,000
Expense Recovery		750
Salaries Expense	1,700	
Depreciation Expense	950	
Insurance—Professional Liability	2,500	
Membership/Professional Dues	200	
Office Supplies/General Expense	500	
Rent Expense	1,800	
Telephone Expense	190	
Total	<u>\$89,390</u>	<u>\$89,390</u>

Net income = Revenue - Expenses

ABC Legal Services Income Statement for the Period Ended December 31, 20**		
Income		
Fees Earned	23,000.00	
Expense Recovery	750.00	
Total Income		23,750.00
Expenses		
Salaries Expense	1,700.00	
Depreciation Expense	950.00	
Insurance—Professional Liability	2,500.00	
Membership/Professional Dues	200.00	
Office Supplies/General Expense	500.00	
Rent Expense	1,800.00	
Telephone Expense	190.00	
Total Expenses		7,840.00
Net Income		15,910.00

PRACTICE
EXCEL

ABC Legal Services Statement of Owner's Equity for the Period Ended December 31, 20**		
ABC, Capital, December 31, 20**		17,165.00
Net Income for December	15,910.00	
Less: Withdrawals for December	5,000.00	
<u>Increase</u> in Capital		10,910.00
ABC Legal Services, Capital, December 31, 20**		28,075.00

Capital comes from Capital in the Trial Balance
increase b/c you took less than was made

PRACTICE

EXCEL

ABC Legal Services Balance Sheet December 31, 20**			
Assets			
Current Assets			
General Bank Account		15,000.00	
Trust Bank Account		35,000.00	
Accounts Receivable		20,250.00	
Prepaid Insurance		700.00	
Prepaid Expense (Rent)		700.00	
Office Supplies		150.00	
Total Current Assets			71,800.00
Fixed Assets			
Computer Equipment (Hardware)			
Less: Accumulated Depreciation on Computer Equipment			
Total Fixed Assets			
Total Assets			
Liabilities and Owner's Equity			
Liabilities			
Accounts Payable/General Liabilities		2,055.00	
Personal Loan		6,000.00	
Credit Card Debt		4,500.00	
Trust Funds Owed		35,000.00	
Total Liabilities			47,525.00
Owner's Equity			
ABC Legal Services, Capital		28,075.00	
Total Liabilities and Owner's Equity			

Fixed assets - Only assets that have depreciation in the trial balance
Capital comes

b. Using the worksheet provided, prepare the closing journal entries and post to the general ledger.

[illegible]

PRACTICE

EXCEL

if it was a debit balance then it should be Credit.

ABC Legal Services
General Ledgers
at December 31, 20**

General Bank Account						Account No. 100	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	✓			Dr.	15,000

Trust Bank Account						Account No. 115	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	✓			Dr.	35,000

PRACTICE**EXCEL****Accounts Receivable****Account No. 120**

Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	✓			Dr.	20,250

Prepaid Insurance**Account No. 125**

Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	✓			Dr.	700

Prepaid Expense**Account No. 128**

Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	✓			Dr.	700

Office Supplies**Account No. 130**

Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	✓			Dr.	150

Computer Equipment (Hardware)**Account No. 155**

Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	✓			Dr.	4,750

Depreciation—Computer Equipment**Account No. 156**

Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	GJ3			Cr.	950

PRACTICE
EXCEL

Accounts Payable/General Liabilities						Account No. 200	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	✓			Cr.	2,025

Personal Loan						Account No. 205	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	✓			Cr.	6,000

Credit Card Debt						Account No. 210	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	✓			Cr.	4,500

Trust Funds Owed						Account No. 215	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	✓			Cr.	35,000

ABC Legal Services, Capital						Account No. 300	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	✓			Cr.	17,165

ABC Legal Services, Drawings						Account No. 350	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	✓			Dr.	5,000

PRACTICE**EXCEL**

Income Summary						Account No. 355	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance

Fees Earned						Account No. 400	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	✓			Cr.	23,000

Expense Recovery						Account No. 410	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	✓			Cr.	750

Salaries Expense						Account No. 511	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓			Dr.	1,700

Depreciation Expense						Account No. 522	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	GJ3			Dr.	950

PRACTICE
EXCEL

Insurance—Professional Liability						Account No. 527	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	GJ3			Dr.	2,500

Membership/Professional Dues						Account No. 534	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	✓			Dr.	200

Office Supplies/General Expense						Account No. 535	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	GJ3			Dr.	500

Rent Expense						Account No. 538	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Balance Forward	GJ3			Dr.	1,800

Telephone Expense						Account No. 565	
Date 20**		Explanation	PR	Debit	Credit	Dr./Cr.	Balance
Dec.	31	Opening balance December 1	✓			Dr.	190

c. Prepare the post-closing trial balance.

PRACTICE

EXCEL

ABC Legal Services Post-Closing Trial Balance December 31, 20**		
Account Titles	Dr.	Cr.